Private Bank

THE EVOLUTION OF DIRECT INVESTING

FOR FAMILY OFFICES

Citi Private Capital Group

2021

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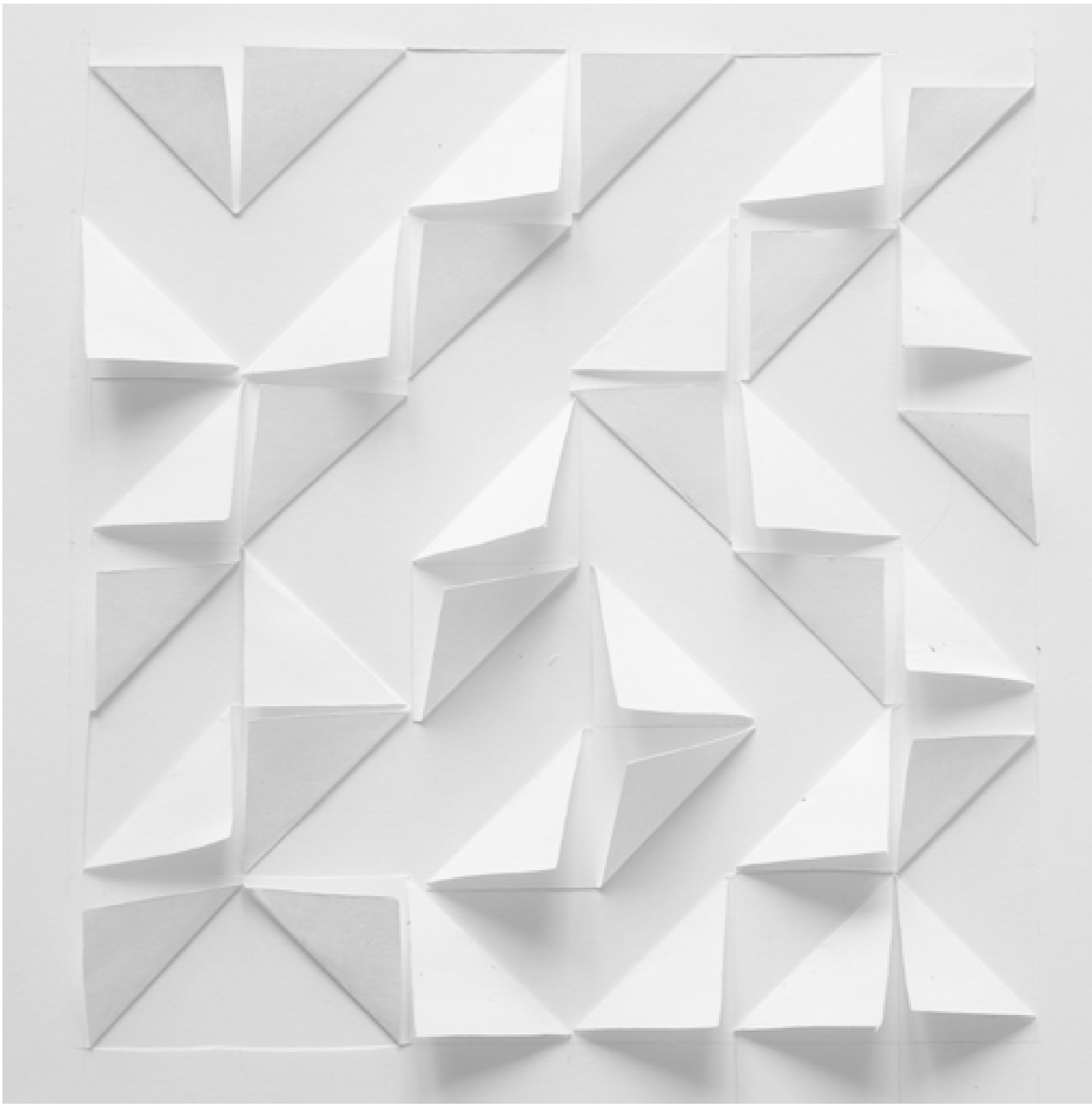

Foreword: Dawn of a new approach to asset allocation

Conventional methods of portfolio construction are being revisited with increasing enthusiasm by family offices and ultra-high net worth individuals in a post-COVID investment climate. The key reason behind this ongoing reassessment of traditional approaches to asset allocation is the rising attraction of direct investment opportunities.

As many family offices have become larger and more sophisticated, their domain knowledge acquired over the years is rapidly nudging them in the direction of higher quality investments and an increased volume of deals often deemed to be unconventional. The desire for having greater control over investments is another powerful motivation as well. Circumnavigating traditional private equity funds and going down the direct route gives family office investors the chance to directly determine which companies to invest in.

Many are proactively seeking disruptive opportunities with future potential in a post-pandemic investment climate. In tune with wide-ranging objectives and demands, and the ability to deploy the patient capital necessary for companies to evolve and expand, we believe direct investments seem to be a natural fit for family offices.

In this white paper we explore this very shift, from passive private equity funds to direct investing, largely based on the findings of our very own *2021 Family Office Survey*. This survey found that 76% of family offices have at least 10% of their total portfolio assigned to direct investments and 44% have at least 25%, exemplifying a shift away from conventional methods of portfolio construction.[1]

While this is consistent with the trend over the past ten years, in this white paper we address some of the common practices to avoid the pitfalls from this prolific growth as family offices continue to develop and expand in-house infrastructure.

We then highlight the thematic opportunities family offices are looking to capitalize on within the private equity space and how they align with *Citi's 2021 Unstoppable Trends*. We hope you find it to be interesting and informative, and as ever we welcome your feedback.

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[1] 2021 Family Office Survey

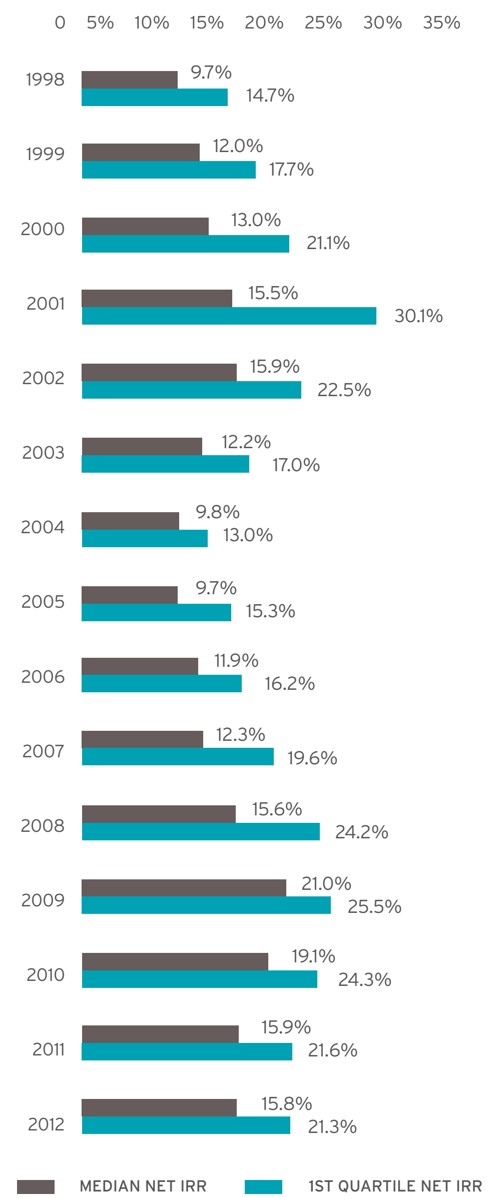
I. The trend: Growth of private equity investing

Our *2021 Family Office Survey* exemplified the continued growth of private equity investing with 47% of respondents revealing they are overweight to the asset class in the next 6 to 12 months.[2] This trend is highly correlated to private equity's market returns. In fact, Citi Private Bank's Global Asset Allocation team has estimated a 2021 strategic return estimate for private equity of 14.2%.[3]

Furthermore, there are strong tailwinds on the back of a global pandemic as 27% of family offices believe private equity is positioned to thrive over the next 3 to 5 years[4]. This outlook is supported by return data as limited partners who invested consistently through prior recessions earned strong returns relative to pre/post crisis vintage performance.

Specifically, US private equity vintage returns averaged 11.5% net median IRR in the two years before the 2000 dotcom and 2008 Global Financial Crisis. Furthermore, average returns improved to a net median IRR of 17.9% in the two years after markets corrected (i.e., 2001-02 and 2009-10 vintages)[5] as noted in Figure 1.

FIGURE 1. U.S. PRIVATE EQUITY RETURNS (NET IRR) BY VINTAGE YEAR



Source: Preqin as of december 31st, 2019, opinion from Citi Private Bank´s Prvate Equity and Real Estate Team.
Past Performance is not indicative of future returns.

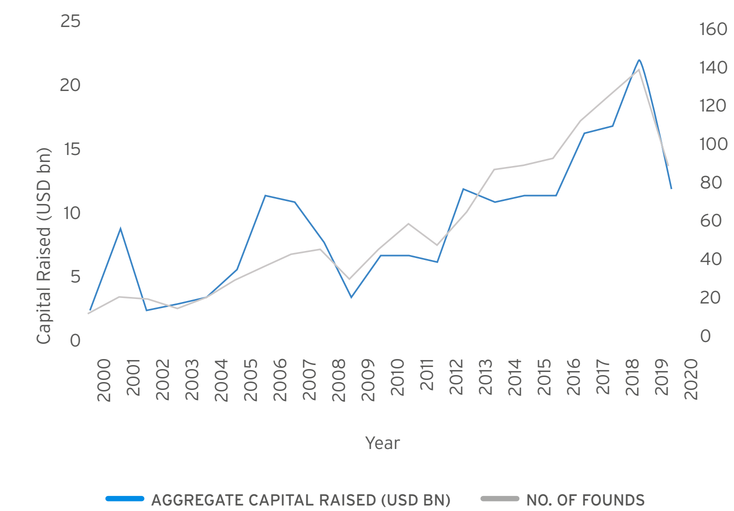
THE RISING TIDE OF 'GOING DIRECT'

As interest continues to rise and family offices increase allocations to private equity, another trend has emerged – that of going direct. Around 44% of all family offices respondents to our *2021 Family Office Survey* reported that over 25% of their portfolio was assigned to direct investments.[6]

A prominent example of this shift is illustrated within the co-investment space. Co-investments allow investors to directly access companies alongside lead sponsors circumnavigating private equity funds. As shown in *Figure 2*, since 2000 there has been an increase in private equity co-investing with an accelerated interest in the last 7 years exceeding over $170 billion raised across over 1,000 funds.

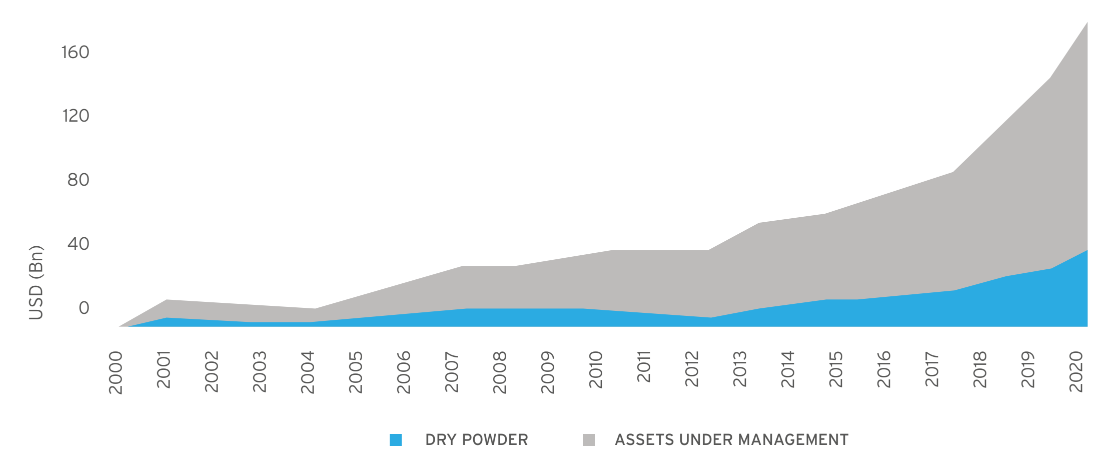
Finally, *Figure 3* reveals that despite a slowdown in 2020, there has been a strong pick up in the past 5 years, with co-Investment assets under management exceeding $120 billion.

FIGURE 2. RISE OF CO-INVESTING



Source: Preqin as of February 2020. Includes Global Co-Investment and Co-Investment Multi-Managers

FIGURE 3. ASSETS UNDER MANAGEMENT



Source: Preqin as of April 28, 2020. Includes Global Co-Investment and Co-Investment Multi-Managers

2 2021 Family Office Survey (June 2021)
3 Citi Private Bank Global Asset Allocation Team, 2021 SRE's based on data through 31 Oct 2020
4 2020 Citi Private Capital Survey (June 2020)
5 Preqin as of December 31st, 2019, Opinion from Citi Private Bank's Private Equity and Real Estate Research and Management team
6 2021 Family Office Survey (June 2021)

II. The rationale: Seeking new ways to invest and manage capital

In a post-COVID investment climate, family offices continue to seek yet newer ways of managing and investing capital as they consistently develop and expand in-house infrastructure. We believe this trend within the family office landscape has helped drive the shift towards direct private equity. The key reasons for such a shift include:

- Increased control and transparency
- Reduced cost and fees
- Alignment of investment strategy with family values and interests
- A growing entrepreneurial spirit

Going direct provides a vehicle for many family offices to realize their goals as single asset investments allow more control and transparency while also potentially providing reduced fees. This method of portfolio construction and increased transparency versus a discretionary fund enables investors to access institutional quality deals which can directly complement family values and interest.

For example, as the wealth transition to the next generation continues, many family offices are shifting their focus from philanthropy to "ESG" or Environmental, Social and Governance investing. The control and transparency of direct investing provides an avenue for family offices to implement an ESG approach as they can target opportunities that directly align with their values, as we noted in a recent whitepaper.[7]

Furthermore, the creation of wealth for many families has been through entrepreneurial ventures, sparking a demand for increased discretion over investments and a preference for management founder-led/ entrepreneurial companies across industries in which they have expertise, connections, and experience in. Many family offices that invest directly believe the direct structure allows them the opportunity to influence the business directly.

[7] Navigating sustainable investing & ESG exposure for family offices, Citi Private Capital Group, Q2 2021

III. Exploring direct private equity thematic opportunities

Family offices are utilizing the increased control and transparency of going direct via co-investing to capitalize on myriad opportunities that align with our *2021 Outlook Unstoppable Trends*. These are powerful multi-year phenomena that are transforming business and everyday life. The events of 2020 and the macroeconomic impact of the COVID-19 pandemic have certainly reinforced our case for investing in these Unstoppable Trends. The latest trends highlighted by us include the transition to a more sustainable world, the rise of Asia, digital disruptors, and demographic changes in the healthcare space, all of which are seeing increased attention across the private equity landscape.

A. DIGITIZATION AND INCREASING LONGEVITY

Family office capital flows in the private equity space are gravitating towards the trends of "digitization" and "increasing longevity" as a pipeline of companies that are successfully innovating with these technologies are growing.[8] In fact, regarding family office direct investing needs, respondents from the *2021 Family Office Survey* named information technology (20%) and healthcare (19%) as two of their three top preferences.

Furthermore, with a strong outlook in these sectors, our data indicated that they are increasing exposure in these areas over the next 12 months.[9] As technology continues to be the future, the tech space amassed 61% of direct investment capital. Furthermore, 44% of family offices investing in private equity allocated towards the healthcare sector.[10] Our 2021 Mid-Year Outlook report examines how digital innovation is revolutionizing industries and how the world's elderly population is growing quite rapidly and addressing the healthcare needs of this population poses many challenges.[11] These trends are creating opportunities for providers of innovative healthcare-related solutions, and other beneficiaries in technology including artificial intelligence, automation, robotics, cybersecurity and fintech.

B. GREENING THE WORLD: ALTERNATIVE ENERGY

Family offices are also expanding their ESG lens to private markets in the areas of ESG investing, with a fifth of family offices during the first quarter of 2021 considering impact investing while sustainable investment funds, ESG screening and investment strategies tailored to sustainability causes found favor with 15% of respondents in each case.[12]

In our 2021 Mid-Year Outlook report we highlight the Unstoppable Trend of "Greening the World", as the investment case for renewables just became even more compelling. The private equity space is a prominent example of this shift towards sustainable investing. As more institutional investors adopt ESG principles, there is a growing demand from institutional investors looking to allocate to ESG-committed funds.[13]

According to a recent Private Capital ESG report by Preqin, in 2020 the average size of ESG-committed private capital funds closed was over $1 billion, compared with five years prior in 2015 where average funds were around $699 million.[14] There is also growing consensus that the world needs to find new and better ways of doing things once the pandemic has receded. Switching to cleaner and more sustainable sources of energy is an obvious example of how we can do this, and private equity, specifically via direct investing, is helping lead the way.[15]

[8] 2021 Preqin Global Private Equity & Venture Capital Report | [9] 2021 Family Office Survey | [10] 2020 FINTRX Family Office Report Part 2 "Analyzing Family Office Direct Investment Activity | [11] 2021 Citi Private Bank Mid-Year Outlook | [12] Citi Private Capital Survey 2020 | [13] "The Rise of ESG", Preqin, November 2020
[14] "The Rise of ESG", Preqin, November 2020 | [15] 2021 Citi Private Bank Mid-Year Outlook

C. RISE OF ASIA: ASIAN DEVELOPMENT IN A "G2 WORLD"

With 70% of family offices in Asia going direct, another Unstoppable Trend that aligns with family office allocations is the "Rise of Asia" as the shift towards the east continues in the private equity landscape.[16] According to a recent survey in Preqin's Global Private Equity & Venture Capital report, "The Rise of Alternatives in the East" (listed as a Preqin 2021 megatrend) reveals that fund private equity managers feel the most compelling opportunities are present in Southeast Asia (50% of respondents) followed by China (38%).[17]

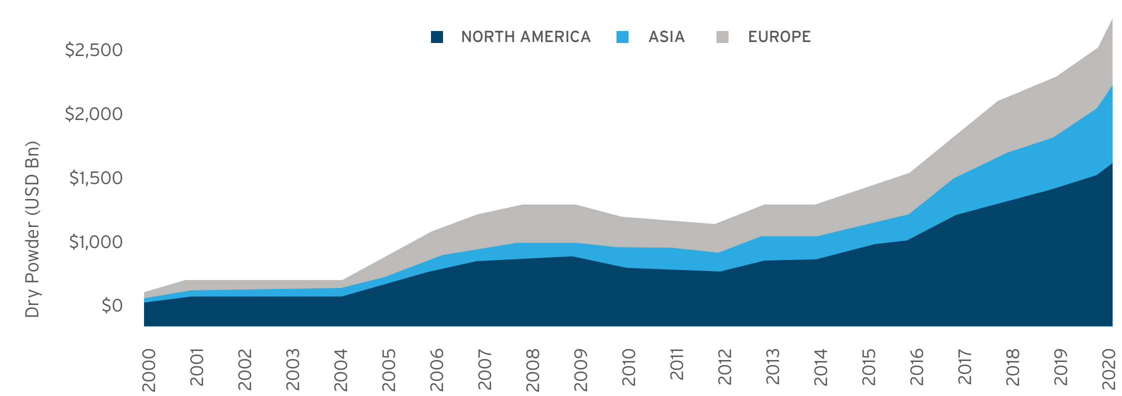
However, this shift is already coming to fruition with the percentage of private equity AUM increasing in Asia climbing to a record 28% in 2020 and has sustained double digit growth since 2011.[18] Asia's share of capital flowing into the private equity space has also increased from 8% in 2016 to 15% in 2020. Preqin expects Asia-Pacific to drive growth in overall private equity AUM over the next five years. The "Rise of Asia" addresses the steady shift in global economic power from West to East, driven by the region's urbanization, growth of the middle class, and advancements in homegrown technologies; developments which offer compelling potential investment opportunities in Asia over the coming decades.[19]

IV. Best practices: Pointers on planning your investment pathways

Direct private equity is an attractive yet challenging investment space which requires a broad skillset and deep resources. Direct opportunities often require investors to move fast conduct due diligence and make final decisions within weeks. This tight turnaround makes it critical for family offices to be proactive to originate high quality deal flow and conduct thorough and consistent due diligence.

The private equity market is a very competitive space and every family office has crafted their own strategy. For example, some family offices capitalize on their unique advantages whether it be industry or operational expertise, a strong network in a particular sector, or unique experience in operating a family business. Of course, every family office has their own special needs. However, regardless of the investment strategy your family office deploys, we have outlined the best practices we believe family offices can apply to help enhance their direct investment approach.

FIGURE 4. DRY POWDER BY REGION



Source: Preqin as of Aril 28, 2020. Includes North America Asia and Europe. All Private Equity.

A. SOURCING

Sourcing high quality and consistent deal flow is a prominent challenge facing family offices in the direct investing space. As shown in Figure 4, the competition for high-quality investments across the private equity landscape has increased steadily over the years due to firms sitting on large amounts of unfunded capital capitals ("dry powder").[20]

Furthermore, the recent SPAC boom has further elevated this competition with approximately 600 companies raising more than $180 billion since the beginning of 2020.[21] With extensive connections, knowledge, and investment capabilities, sophisticated family offices have been very active in this space and these SPACs have generated further competition for deals. In this competitive environment family offices need to be proactive and can benefit from utilizing a

16 Preqin Global Private Equity & Venture Capital Report, Mid-Year Outlook 2021
17 Preqin Global Private Equity & Venture Capital Report, February 2021
18 Preqin Global Private Equity & Venture Capital Report, February 2021
19 2021 Citi Private Bank Mid-Year Outlook
20 Global Investment Lab, Preqin and Bloomberg Analytics as of May 29th, 2020
21 Family Offices Targeting 800% Returns With SPAC Economics, Bloomberg Law, 16 April, 2021 https://news.bloomberglaw.com/mergers-and-acquisitions/family-offices-are-targeting-800-returns-with-spac-economics

specific strategy to improve their origination efforts. Strategies may include:

- Developing a trusted relationship network
- Leveraging family-owned business or industry expertise
- Partner with institutional intermediaries or banks

Family offices should also utilize their unique advantages, outsource, or a combination of both to ensure consistent deal flow. Many family offices have built and continue to broaden connections through networking organizations and events such as family office roundtables, affinity groups, etc. These forums are vital to help build a trusted network of relationships to source investment opportunities but also a great channel to share best practices and exchange market insights.

In addition, many family offices may operate a business and possess industry expertise which they can leverage as a competitive advantage to win favors on access to opportunities over other prospective investors. And many family offices with no in-house resources to conduct proactive origination may look to partner with financial intermediaries like banks who provide them a wide variety of consistent flow to institutional quality deals while also empowering them to streamline their own processes.

Whatever the strategy a family office deploys, high quality deal flow is essential to every direct investing approach and family offices should look to leverage their unique advantages, outsource through a financial intermediary or use a hybrid approach.

B. DUE DILIGENCE

Family offices operate like other institutions with processes, procedures, and controls in place to evaluate, approve, and oversee investments. In fact, many family offices now have the ability to evaluate potential direct opportunities as they look to hire investment professionals with private equity background and continue to develop in-house investment infrastructure as well as expand operational teams. Successful direct investors conduct thorough and consistent diligence to help mitigate risk. Outlined here are ten key considerations we believe every family office should look at during the due diligence process.

TEN KEY CONSIDERATIONS

WHAT IS THE TERM SHEET?	The term sheet is a nonbinding agreement outlining the basic terms and conditions for the investment. It provides investors with a high-level understanding of the deal dynamics including the company valuation, liquidation preference, voting rights, etc. A strong understanding of the term sheet is essential to begin a thorough due diligence process.
WHAT IS THE TIMELINE OF THE TRANSACTION?	There are various steps involved in a direct private equity transaction timeline including receiving a teaser, executing a non-disclosure agreement, calls with the management team, closing, etc. With tight turnarounds in the direct investing space, investors need to have a firm understanding of the timeline and be able to move along the due diligence process accordingly.
WHO IS THE LEAD SPONSOR?	Lead sponsors "anchor" the fundraising round, including establishing the term sheet. Family offices may also look to invest behind a sponsor with a strong track record, name recognition/reputation, and have relevant industry/business sector expertise in respect to the company to enhance their own due diligence process.
WHY IS THERE CAPACITY FOR FAMILY OFFICES? WHAT IS THE TOTAL CAPITAL RAISE AND ALLOCATION AVAILABLE?	Considering why family office investors have access to the opportunity is essential for understanding where this deal is coming from, why it is being shown, and how trusted it is. Investors will also need to understand the total raise, the allocation available and if there are any minimums/maximums when determining their commitment amount. Additional considerations include what existing shareholders are participating in the round, is there Right of First Offer (ROFR), and will there be any secondary opportunities.
HOW IS THE MANAGEMENT OF THE CAP TABLE? WHO ARE THE EXISTING SHAREHOLDERS?	The capitalization table shows the equity ownership of a company. The "cap table" is important during new capital issuances and is essential for new investors to understand what they are buying as it will reveal your percentage ownership and an investors ability to control change in the company. It is also important to understand who the existing shareholders are, as a strong cap table can help add strategic value to the company through a shareholder's industry expertise, relationships, and/or their network to foster growth.
WHAT IS THE COMPETITIVE LANDSCAPE?	A competitive landscape analysis will help the investor understand the risk/opportunities for the investment in the market. Investors should have a clear picture of the total addressable market (TAM) to keep a finger on the pulse of the revenue opportunity available for the product or service. Additional considerations include the company's intellectual property (IP) and the ability of the competition to gain access to the same IP.
WHAT IS THE VALUATION AND HOW IS IT DERIVED?	Before you invest in a company you need to know how much its worth. The methodology used to calculate the valuation can range from utilizing private comps, public comps, or a discounted cash flow analysis. Investors must have a firm understanding of the mechanics behind a valuation to understand if the company is under or overvalued. Valuation is determined by the lead sponsor and is included in the term sheet.
WHAT ARE THE BASE, UPSIDE, AND DOWNSIDE CASE RETURNS? WHAT ARE THE KEY ASSUMPTIONS FOR THE RETURN PROFILE?	The lead sponsor may conduct a scenario analysis to evaluate possible events or scenarios that could take place in the future. Family office investors should leverage, to the extent possible, the intellectual capital of the lead sponsor to help determine key assumptions when predicting various outcomes. This is important when it comes to future planning and determining the risk/reward equation.
WHAT IS THE REVENUE AND THE KEY PRICING SUPPORT (MULTIPLES, ETC.) VS COMPS?	Another important consideration when assessing the value of a company is analyzing its comparables. Investors should first compile a refined list of companies that are in a similar growth stage and industry. Leveraging this list to conduct research on the financial multiples, averages, ratios, and benchmarks to understand how the company you are considering stacks up against them.
WHAT IS THE EXIT PLAN? KEY RISKS OF EXIT PLAN? TARGET HOLD PERIOD OF INVESTMENT?	The exit strategy is executed by the company or investor to liquidate a position in order to meet its profit objective. It is important to understand the strategy i.e. an IPO, acquisition, or buyout and how the current market conditions might influence the execution.

C. PORTFOLIO MANAGEMENT

A key finding from *Citi Private Capital Survey 2020* highlighted that the top three public market sectors where family offices intended to increase investment exposure corresponds to their private and direct allocations in these sectors which already dominate their public market allocations.[22] This insight helps emphasize the importance of robust portfolio management which is the key to achieving long-term returns and objectives, as well as protecting against losses and potential risks. Investment management takes time and sophistication.

Many family offices are very small in size with only one or two employees who rely on service providers as much as possible for portfolio advice, investment strategies, and consulting on solving their investment problems. Other family offices that are more sophisticated may have in-house resources who can help in consolidation, performance monitoring, and risk management. No matter the approach family offices should design a strategic long-terms asset allocation around their private capital concentration.

When family offices construct a portfolio, they should consider exposure towards their private capital investments and to help mitigate potential risks associated with high exposure towards private equity. The main objective during portfolio construction should be to create a portfolio allocation that helps maximize the portfolio return given specific limited parameters such as volatility and downside risk. By understanding asset correlations and their relationship with your private equity sleeve, strong portfolio construction may help to diversify an overall allocation and potentially reduce volatility and improve risk-adjusted returns.

In conjunction with building a strategic allocation, family offices should look to conduct portfolio management best practices on a regular basis including:

- **Overlap analysis** - Highlights those positions in which the portfolio is too concentrated
- **Gap analysis** - Highlights areas the portfolio is underweight from an asset allocation perspective
- **Stress test** - Run historical scenarios to help mitigate unexpected events

In summation, we believe these practices can help family offices gain the insight necessary to answer many portfolio constructions questions around both direct investing approaches and pathways, and how they can align direct investments with their total portfolio. In addition, they can help pinpoint the degree to which your portfolio is poised to take advantage of these industry changes and market forces.

22 Citi Private Capital Survey 2020 (June 2020)

About the 2021 Family Office Survey

The 2021 Family Office Survey was conducted as part of Citi Private Bank's 2021 Family Office Leadership Program, held from 7 to 10 June 2021. While the program ran during the said week, polling for the survey was conducted online over a longer period from 25 May to 12 June 2021.

The survey included over 20 questions aimed at gauging investment sentiment and portfolio actions of clients anonymously in the wake of macroeconomic headwinds created by the COVID-19 global pandemic and the subsequent recovery. It drew responses from a total of 197 participants. Of the stated number of respondents, 156 (or 79%) were those with family offices, while the remaining 41 (or 21%) were ultra-high net worth individuals who do not have a family office.

Geographically speaking, of the 156 family office respondents, the survey received 66 responses from North America accounting for 42% of the total sample pool. The number of respondents from Europe, Middle East and Africa came in at 34 (or 22% of the sample pool), followed by Latin America with 32 (or 21%) and Asia Pacific with 24 (or 15%). In total, the respondents hailed from over 100 different countries.

For statistical purposes and the respondents' questionnaire, the US dollar was the valuation currency of the survey. Of the total number of family office respondents, 20 (or 13% of the sample pool) had more than $2 billion in assets under management (AUM); 14 (or 9%) had AUM in the $1 billion to $2 billion range; 29 (or 19%) in the $500 million to $1 billion range; 33 (21%) in the $200 million to $500 million range while 60 (38%) had under $200 million in AUM.

Credits

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Glossary

ASSET CLASS DEFINITIONS:

Cash is represented by US 3-month Government Bond TR, measuring the US dollar-denominated active 3-Month, fixed-rate, nominal debt issues by the US Treasury.

Hedge Funds are composed of investment managers employing different investment styles as characterized by different sub categories – HFRI Equity Long/Short: Positions both long and short in primarily equity and equity derivative securities; HFRI Credit: Positions in corporate fixed income securities; HFRI Event Driven: Positions in companies currently or prospectively involved in a wide variety of corporate transactions; HFRI Relative Value: Positions based on a valuation discrepancy between multiple securities; HFRI Multi Strategy: Positions based on realization of a spread between related yield instruments; HFRI Macro: Positions based on movements in underlying economic variables and their impact on different markets; Barclays Trader CTA Index: The composite performance of established programs (Commodity Trading Advisors) with more than four years of performance history.

Private Equity characteristics are driven by those for Developed Market Small Cap Equities, adjusted for illiquidity, sector concentration, and greater leverage.

OTHER TERMINOLOGY:

Adaptive Valuations Strategies is Citi Private Bank's own strategic asset allocation methodology. It determines the suitable long-term mix of assets for each client's investment portfolio.

AUM or assets under management are the total market value of the investments that a person or entity handles on behalf of investors.

Correlation is a statistical measure of how two assets or asset classes move in relation to one another. Correlation is measured on a scale of 1 to -1. A correlation of 1 implies perfect positive correlation, meaning that two assets or asset classes move in the same direction all of the time. A correlation of -1 implies perfect negative correlation, such that two assets or asset classes move in the opposite direction to each other all the time. A correlation of 0 implies zero correlation, such that there is no relationship between the movements in the two over time.

IRR or Internal Rate of Return is the expected compound annual rate of return that will be earned on a project or investment.

LIBOR or London interbank offered rate is the rate of interest at which banks offer to lend funds to each other. It is used a reference rate for large amounts of financial contracts.

Sharpe ratio is a measure of risk-adjusted return, expressed as excess return per unit of deviation, typically referred to as risk.

SPAC, short for Special Purpose Acquisition Company, also known as a "blank check company", is a shell corporation listed on a stock exchange with the purpose of acquiring a private company, thereby making it public without going through the traditional initial public offering process.

Strategic Return Estimates (SRE) are based on Citi Private Bank's forecast of returns for specific asset classes (to which the index belongs) over a 10-year time horizon. The forecast for each specific asset class is made using a proprietary methodology based on the assumption that equity valuations revert to their long-term trend over time.

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